

CAPITAL PROJECTS AND BOND OVERSIGHT COMMITTEE

Minutes

October 18, 2005

The Capital Projects and Bond Oversight Committee met on Tuesday, October 18, 2005, at 10:00 AM, in Room T-111 at the Maysville Community and Technical College. Representative Mike Denham, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Representative Mike Denham, Co-Chair; Senator Elizabeth Tori, Co-Chair; Representatives Robert Damron, Paul Marcotte, and Jim Wayne; and Senator Dan Seum.

Guests testifying before the Committee: Brian Furnish, Governor's Office for Agricultural Policy; Tom Howard, Office of Financial Management; Bob Wiseman and Marc Mathews, University of Kentucky; John Hicks, Governor's Office for Policy and Management; Jim Abbott, Finance and Administration Cabinet; Dr. Augusta Julian, Maysville Community College; and Dr. Michael McCall, Kentucky Community and Technical College System.

LRC Staff: Mary Lynn Collins, Nancy Osborne, Kristi Culpepper, and Shawn Bowen.

Representative Denham welcomed everyone to the meeting in Maysville, and announced that donations were being accepted for the Legislative Research Commission Hurricane Relief Fund project.

Representative Denham explained that the Committee's role is to oversee the issuance of bonds by the Commonwealth, as well as capital projects throughout Kentucky. He then asked each Committee member to introduce themselves, and asked Ms. Mary Lynn Collins, Committee Staff Administrator, to introduce the Committee staff.

Representative Denham then introduced Dr. Augusta Julian, President and CEO of Maysville Community and Technical College. Dr. Julian welcomed Committee members and local dignitaries to the college.

Representative Denham recognized Representative John Will Stacy who was attending the meeting as a guest.

Representative Marcotte made a motion to approve the minutes of the September 20, 2005, meeting. The motion was seconded by Senator Seum and approved by unanimous voice vote.

Representative Denham called on Ms. Collins to review correspondence items. Ms. Collins said members' folders included three items of follow-up correspondence: correspondence from the Division of Water relating to Kentucky's Dam Safety Program and State-Owned Dams; correspondence from the Department for Facilities and Support Services in response to questions raised at the Committee's September meeting regarding the Louisville Arena Task Force contract with LG&E Energy; and correspondence from the Division of Real Properties transmitting information requested by the Committee at its September meeting regarding state-owned property in Fayette County and properties administered by the Cabinet for Economic Development.

Also included in Committee folders were a notice of the plan by the University of Louisville (U of L) to use the Construction Management-at-Risk project delivery method for the Health Sciences Center Research Facility Phase III project; a report submitted by U of L regarding unbudgeted equipment purchases; and the Kentucky Lottery Corporation's monthly financial report for August 2005.

Representative Denham then introduced Brian Furnish, Deputy Director, Governor's Office of Agricultural Policy (GOAP), who updated the Committee on the Phase II Tobacco Settlement Program. Mr. Furnish said the 2005 General Assembly decided to make Phase II tobacco buyout payments to Kentucky farmers in lieu of the 2004 payment they were to have received through the National Tobacco Growers Settlement Case that was being contested in court. Mr. Furnish said Kentucky was the only state that went ahead and made 2004 Phase II payments directly to farmers. When the tobacco buyout was passed by Congress, and the tobacco manufacturing companies filed suit saying they did not have to make their 2004 Phase II payments, the state issued bonds and made the payment this year.

Mr. Furnish said the courts are now requiring the National Tobacco Growers Settlement Trust to make the first three of the quarterly payments for 2004 including interest, directly to the states. He said within the next three weeks, Kentucky anticipates receiving approximately \$93 million, depending on legal fees and the interest rates. That money will go back to the Commonwealth since farmers assigned to the state their rights to the moneys under the Trust Fund as a condition of receiving state payments.

Mr. Furnish said the fourth quarter payment is currently being argued in court, and a ruling is expected within the next few days. The tobacco manufacturing companies are arguing that they should not have to make the 2004 fourth quarter payment since they are making the 2005 payment, and the tobacco growers are arguing that the payment was

supposed to be made before January 1, 2005. He said they expect the Judge to rule in the tobacco growers favor, but if not, the decision will be appealed to the North Carolina Supreme Court.

Representative Denham said if the Judge rules that the fourth quarter payment should be made, Kentucky will receive a total of approximately \$124 million from the Trust Fund for the 2004 Phase II payments. Up to \$114 million will be allocated to GOAP based on the state statutory amount that Kentucky made available in lieu of the contested Trust Fund payments. Representative Denham asked what will happen to the other \$10 million if the Judge allows the fourth quarter settlement to be paid. Mr. Furnish said if the court ruled in the tobacco growers favor, the other \$10 million, which is the amount actually owed under the Trust Fund versus the amount specified in Kentucky statute, will be disbursed and refunded back to farmers.

Representative Denham noted that a number of farmers did not receive a Phase II tobacco payment because of paperwork and administrative problems. He asked how much money is remaining in the Phase II account, and if there is an appeals process for farmers to get that money. Mr. Furnish said they had an appeals process last year for those farmers who did not get their 2004 payment. People who had not signed up before were allowed to sign up by a deadline. The Trust now has a database for those who are to receive the 2004 payment. He said if farmers missed that deadline, there is no mechanism to make payment to them unless the General Assembly appropriates money and directs that to be done. Mr. Furnish said his office realizes that some people have called and complained, but they had no legal way of making the 2004 payment to those people.

In response to a question by Representative Denham, Mr. Tom Howard, Executive Director, Office of Financial Management, said the interest cost on the bonds issued by the state for the Phase II payments is at an all-time low. He said OFM would propose not redeeming the bonds when the state receives the tobacco settlement money, but that those funds instead be used for other capital projects approved by the General Assembly.

Representative Denham asked what kind of interest rate the state will get if the bonds are refunded. Mr. Howard said the first call is not until May 2025, so a defeasance account would have to be established. He said OFM did not see any need to go through that process since there are other capital needs, and in today's market, the borrowing yield would be expected to be 4.5% versus 4.19% from the May issue.

Next, Mr. Bob Wiseman, Associate Vice President for Facilities, University of Kentucky (UK), discussed a \$150,000 scope increase for the UK Football Practice Fields Renovation project. Mr. Wiseman said the scope was increased due to the need to remove more subsurface rock at the site than was anticipated. In addition, due to an abnormally wet April and May, the University was unable to sprig the field and had to use sod instead.

Representative Wayne asked when the change order for this project was approved. Mr. Wiseman said the University worked hard to get the final amounts from the contractor in late August. Mr. Wiseman said he recognized they should have brought this request to the Committee in September.

In response to another question from Representative Wayne, Mr. Wiseman said the prevailing wage applied across the board for this project.

Representative Marcotte made a motion to approve the scope increase for the UK Football Practice Fields project. The motion was seconded by Senator Tori and passed by unanimous roll call vote. The revised project scope is \$2,400,000.

Representative Denham asked Mr. John Hicks, Acting Deputy State Budget Director, Governor's Office for Policy and Management, and Mr. Jim Abbott, Commissioner of Facilities and Support Services, Finance and Administration Cabinet, to present the Finance Cabinet's monthly report to the Committee. Mr. Hicks reported a correction to an allocation amount reported to the Committee in August 2005 by the Department of Fish and Wildlife Resources on the acquisition of 500 acres known as the Bailey tract in Fleming County. Mr. Hicks said they inadvertently omitted the inclusion of \$23,200 in survey costs for the land. The total acquisition value was \$505,700, and not \$482,500 as previously reported.

Mr. Hicks then reported another land acquisition project for the Division of Forestry, Department for Natural Resources. The Kentucky Heritage Land Conservation Fund Board awarded \$500,000 to the Division of Forestry to acquire 250 acres in Carter County adjacent to the Tygarts State Forest. He said when combined with Carter Caves State Resort Park, this acquisition will create a contiguous forest of 2,209 acres.

Representative Denham said no further action is required for these land acquisitions.

Representative Denham said he thought the people in Carter County and Fleming County would be excited about these two acquisitions.

Mr. Abbott next reported a lease renewal with a rate increase for the Cabinet for Health and Family Services in Franklin County. The Cabinet has paid \$360,906 annually for the office and warehouse space since July 1998. Mr. Abbott said the lease was bid competitively, and there were two responses to the ad. The existing lessors, Leestown Partners, Ltd., offered the lowest price at an annual cost of \$419,103.

Senator Tori made a motion to approve the lease renewal for the Cabinet for Health and Family Services. The motion was seconded by Representative Wayne and passed by unanimous roll call vote.

Ms. Collins reported fourteen Coal/Tobacco Development Grants approved in the 2004-06 budget. No further action was required on these projects.

Representative Denham said he had a discussion with Kentucky Infrastructure Authority (KIA) staff this past week, and noted that the water and sewer projects are moving along rapidly. He said KIA has placed over 10,000 miles of new waterlines.

The next report was provided by Mr. Howard. He reported one new bond issue: Kentucky Asset/Liability Commission (ALCo) University of Kentucky General Receipts Obligation Project Notes, 2005 Agency Fund Third Series. Mr. Howard introduced Mr. Marc Mathews, Comptroller, University of Kentucky. Mr. Howard said the proceeds from this bond issue, \$100,000,000, will be used in part to fund the UK Hospital expansion, which the General Assembly approved last session. The bonds will be sold on October 24, 2005, to raise \$100,000,000 plus capitalized interest, to carry the project through a two-year construction phase, at which time revenues are expected to pick up the debt service on the bonds.

Mr. Howard said currently UK and OFM are evaluating the insurance, and it appears that the ratings on these bonds will be Aa3 by Moody's and AA- by Standard & Poor's. He said the true interest cost is expected to be approximately 4.48%, the call date to be October 1, 2016, and the maximum annual debt service to be \$9.9 million. Mr. Howard said the bond issue will be a negotiated sale with Morgan Stanley as the underwriter; Peck, Shaffer and Williams as bond counsel; and Thompson Hine as the underwriter's counsel.

Mr. Howard said this is a rather unique transaction. The University is in the process of combining three existing bond indentures under a single general receipts pledge. The three indentures to be combined are the Consolidated Educational Building Revenue Bonds (CEBRB) System, the Hospital System, and the Housing and Dining System.

Representative Wayne asked if the University is adopting this new debt program in order to increase its debt capacity. Mr. Howard said the purpose of combining these indentures is to lower the overall volume and cost to the University. He said by combining the general receipts pledge, the University will be relieved of certain onerous provisions that the existing bond indentures have, it allows them to eliminate the need for a debt service reserve account, and also allows the University to achieve a lower volume cost because they are not splitting the revenue streams from the three different indentures. The hospital is going to be a significant portion of the University's borrowing in the

coming years, and the lower cost will mean more dollars for the hospital over the long run.

Mr. Mathews added that the indentures they are combining have existed since 1960 and served them well. However, the University's advisors have indicated that using the three indentures is a segregated approach, and has not provided the University the lowest cost of capital. He said with the recommendation of the rating agencies, the University's underwriters, and OFM, UK determined that the combined credit provided the lowest cost of interest and the greatest security to bondholders.

Representative Wayne asked why the compensation rate for bond counsel is higher than the compensation rate set for ALCo issues through a competitive bidding process. Mr. Howard said they are requesting Committee approval today to increase the established rate. He explained that the bond counsel's contract was not up for renewal, but when it was negotiated, they did not contemplate such a complicated hospital transaction or plan condensing three separate trust indentures into a single general receipts pledge. The set rate is \$0.235 per bond (\$23,500 total), and UK is requesting increasing the rate to \$.50 per bond (\$50,000 total). The contract was bid in 2004 for all state universities, and had UK selected to issue bonds on a competitive sale basis on its own, it would have paid approximately \$1 per bond (\$100,000 total) for those bond counsel services. He noted that the proposed rate represents a median between those two.

Senator Seum asked if the other state universities plan to use this method to restructure their debt. Mr. Howard said OFM will discuss with each state university the benefits that a general receipts pledge would offer, and allow them the opportunity to consider what is right for their circumstances.

In response to another question from Senator Seum, Mr. Howard said if the University restructures its debt, it will not affect the state's overall bonding capacity.

Representative Damron said when ALCo issues these bonds, there will be a stronger case made that UK's hospital and auxiliary debt is part of the state's bonded indebtedness cap, which an effort was made to avoid this in the last session with HB 45 which the House passed but not the Senate. He said this bond issue is University debt, and he understood why the University put the indentures together, but he questioned why ALCo was the issuer rather than UK.

Mr. Howard said given the change to the credit structure of the University, University officials felt that it was in their best interest to do these obligations on a negotiated basis initially, and OFM did not disagree with that. (University issues are required by statute to be sold competitively.)

Representative Damron asked how the taxpayers of the Commonwealth can be assured that the University is getting the best deal when the sale is negotiated instead of bid competitively. Mr. Howard said this bond sale will be compared to all the other sales, and since the bond sale will be negotiated, it will be offered to people of the Commonwealth first during a retail priority period. He said they are hoping the bulk of these bonds will be sold to Kentucky residents who will benefit from the state and federal exemption.

Representative Damron asked if OFM plans to use swaps for this financing. Mr. Howard responded that this is a traditional 20 year fixed rate transaction, and no swaps will be used.

Representative Damron asked if legislation similar to HB 45 (2005 session) is passed, which would take auxiliary and hospital debt out of debt calculations, will this particular issue be locked into the state's bonded indebtedness since it is issued under ALCo. Mr. Howard responded that these bonds are secured by University receipts, so if there is a change in the way the receipts are treated, they could be exempt. He said he would not think that because ALCo is issuing them that it would necessarily count as state debt.

Representative Damron said he did not understand why the University is using ALCo to issue the bonds, instead of issuing it themselves. The bonds have ratings of AA and there is no bond insurance, which is strong evidence that the University's debt structure is solid and marketable. He said he did not understand why the issues are being done on a negotiated basis and why ALCo is being used when UK can stand on its own.

Mr. Mathews said the University asked ALCo to issue the bonds for them because it is a negotiated sale. He said they first wanted ALCo involved two years ago when they anticipated a great cost savings to the institution if they were able to be issue variable rate bonds. Now that the interest rate structure is such that the variable rates are not attractive, as compared to locking in today's rates permanently. The one advantage that remains with ALCo as issuer is the negotiated sale. He said the University was advised by both the rating agencies and the underwriters that with a new credit of this size, they would have a better opportunity to lower those costs through having the opportunity to discuss, through a negotiated sale, the structure, the credit, and the proformas.

Representative Damron said when dealing with taxpayer and public dollars, bonds should be competitively bid. He said by negotiating this bond issue, the University will not know if it is getting the best deal possible. He said he personally opposed not competitively bidding the bond issue.

Representative Damron asked why the University is capitalizing \$19,000,000 in interest. Mr. Mathews said that amount has been revised downward. It will now cover a

two-year period to allow the University to build its revenue stream. He explained that there is significant cash on hand and there will be significant cash remaining through this project, and that is part of the reason the University has been able to sustain its rating. He said they are trying to keep the cash at approximately a \$200,000,000 level through the entire project.

Representative Damron said holding this amount of cash means the University is paying interest on interest. He said this bond issue does not seem structurally well developed, and asked how the University can justify paying interest on interest. Mr. Mathews said they would like to maintain the cash at a desired level to support the ratings. He said if you look at the proformas during the first two periods, UK Hospital will raise the revenues significantly to start paying principal and interest on these bonds.

Senator Seum asked who will be responsible for the debt if UK cannot service it. Mr. Howard said if UK cannot service the debt, there is a state intercept provision, KRS 164A.608, whereby the Secretary of Finance can intercept future appropriations to the University to make the payment due. Mr. Howard said the state would find a way to make sure that obligation is paid.

Senator Tori asked when the ratings for this bond issue will be determined. Mr. Howard said the ratings have been preliminarily released to OFM, but they have not been officially released to the marketplace. They expect the ratings to be Aa3 by Moody's, and AA- by S&P, and they should be released to the marketplace within the next two days.

Representative Damron said it was his understanding from one of the rating agencies that there has not been adequate communication from the Finance and Administration Cabinet in regard to the intercept provisions that are in place on the university bonds. He asked if OFM has followed-up with the rating agencies and clarified that there is an intercept in place and it applies to University issues. Mr. Howard said he has had extensive discussions over the last eight weeks with the rating agencies regarding the intercept provisions.

Representative Damron said he understood that there was some discussion as to whether the statute regarding the state intercept needed clarification. Mr. Howard said the rating agencies have not made a decision regarding this yet, but he would be happy to pass that information along once he knows the conclusion. Representative Damron asked that he be notified if OFM thinks something needs to be clarified in the intercept statute, because the legislative intent was to enhance bond ratings for university issues.

Senator Tori made a motion to approve Kentucky Asset/Liability Commission UK General Receipts Obligation Project Notes, 2005 Agency Fund Third Series (New Patient Care Facility - UK Hospital). The motion also included approval of a request to compensate at a revised rate Peck, Shaffer & Williams. The motion was seconded by

Representative Marcotte, and passed by roll call vote. Five members voted affirmatively. Representative Damron passed based on his opposition to negotiated bond sales on public bidding.

Representative Denham noted that the Committee folders also included the Semi-Annual Report of the Kentucky Asset/Liability Commission. Representative Damron noted that ALCo was using swaps to hedge its Tax and Revenue Anticipation Note (TRAN). He asked Mr. Howard what kinds of fees the state was paying for swaps. Mr. Howard said he did not know what the fees were, but they were competitively bid among three dealers to get the lowest rating.

Representative Damron asked if the statute allows swaps and derivative products. Mr. Howard said according to the statute that governs ALCo, financial agreements are specifically permitted and swaps are a form of a financial agreement.

In response to another question from Representative Damron, Mr. Howard said he was familiar with the August 18, 2005, article published in the Bond Buyer regarding excessive fees being paid to swap brokers. He said he was also aware the IRS is putting more attention on swap fees. Mr. Howard said OFM is looking at swap fees, and he would follow-up and let the Committee know what the TRAN swap fees were.

Representative Damron said swap fees are a significant issue right now in the bond market industry, and the IRS is turning its attention to swap fees and excessive charges. He said the state should be cautious in using swaps because there is the potential for abuse.

Also included in members' folders were two follow-up reports for three previously approved bond issues: Kentucky Higher Education Student Loan Corporation Student Loan Revenue Bonds, Senior Series 2005 A-1 through Series 2005 A-7, \$400,000,000; State Property and Buildings Commission Revenue Bonds, Project No. 85, \$218,275,000; and State Property and Buildings Commission Agency Fund Revenue Bonds, Project No. 86, \$5,840,000. Representative Denham said these follow-up reports were for bond issues previously approved, and no further action was required.

Mr. Howard next presented five new school bond issues with School Facilities Construction Commission (SFCC) debt service participation: Covington Independent (Kenton Co.); Jackson County; and Washington County (3).

Senator Tori made a motion to approve the five school bond issues. The motion was seconded by Representative Wayne and passed by roll call vote. Five members voted affirmatively. Representative Damron abstained from the vote, citing a potential conflict of interest.

Representative Denham said the debt issuance calendar was also included in members' folders. No action was required for this report.

Representative Denham invited Dr. Michael McCall, President of the Kentucky Community and Technical College System, and Dr. Julian to discuss current and future capital projects at the Maysville Community College and at the other KCTCS campuses.

Dr. McCall briefly discussed the process the community colleges use to submit their capital project requests. Dr. Julian then presented a PowerPoint presentation regarding the Maysville Community College.

Representative Marcotte thanked Dr. Julian for her presentation. He then asked her for an overview of the courses of study offered by the college. Dr. Julian said they have a comprehensive set of offerings, including degrees in business and technology, HVAC, welding, diesel, practical nursing, surgical technician, and a number of other technical programs.

In response to questions from Representative Marcotte and Senator Seum, Dr. Julian said the placement rate for nurses is very good because there is constant turnover. Dr. McCall added that KCTCS is working very closely with all the hospitals to create a nursing pool to try to fill some of the voids they are having right now. He said the average starting salary for a nurse is \$45,000.

Representative Wayne thanked Dr. McCall and Dr. Julian for their good work. He said strong leadership at this level was essential, and he asked about faculty salaries. Dr. McCall said the KCTCS Board of Regents has consistently for the last six years addressed the needs of the faculty, and it has been their number one priority. He noted that the Board of Regents has dedicated an additional \$2.5 million to address salary issues, and employees have been given substantial raises over the last seven years.

Representative Damron asked if KCTCS plans to propose a modification of the composition of its Board. Dr. McCall said at issue is how KCTCS was initially created. The KCTCS Board of Regents is made up of eleven members, eight appointed by the Governor and three selected by the staff and students. At KCTCS, they were given two faculty, two staff, and two students, with a half a vote each, which means there are 11 votes on the board, and fourteen voices. Dr. McCall said the Board is proposing to change from six elected members to three elected members - one faculty, one staff, and one student. He said they have taken a very proactive approach regarding this, and are holding public forums throughout the state colleges this month to get employee input.

Representative Stacy asked how KCTCS prioritizes the projects it submits to the General Assembly for funding. Dr. McCall said once the individual institution determines its needs and submits them to KCTCS, the projects are reviewed and ranked based on

factors that are weighted. Representative Stacy requested that information regarding this process be forwarded to the Committee. He said it would be instructive for the Committee to know how KCTCS determines its needs, and it would help the General Assembly work with KCTCS to fill those needs.

Representative Denham then introduced special guests, local community leaders, and school board members.

With there being no further business, the meeting adjourned at 11:30 a.m. Committee members and other invited guests then toured the Community College and the Mason County Intermediate School.